

Placee Independence – Key Takeaways from the Latest SFC Disciplinary Actions

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Introduction

The Securities and Futures Commission (**SFC**) announced on **May 21, 2014** and **December 10, 2014** that it had disciplined a Type 6 corporate finance adviser (**A**), its affiliated Type 1 broker entity (**B**) and a former responsible officer of the broker (**C**) for their failures to ensure the independence of all placees in an initial public offering (**IPO**) in 2009. Each of A and B was publicly reprimanded and fined \$12.5 million, while C has been suspended for eight months.

These enforcement actions come on the back of the Hong Kong IPO sponsor reforms and the SFC's increased focus on the responsibilities of senior management of intermediaries. The disciplinary sanctions are a strong reminder to IPO sponsors that they have a duty to ensure the integrity of the IPO market; in particular, they should ensure that they are not used as a conduit to manipulate placing restrictions.

Key Takeaways

1. Placee independence is under close scrutiny by the SFC.
2. Know-your-client (**KYC**) due diligence is one key to ensuring placee independence. An Intermediary must conduct customer due diligence and perform ongoing scrutiny of accounts of placees to reasonably satisfy itself that the transactions being conducted in these accounts are consistent with the intermediary's knowledge of the placees, taking into account their financial capability and source of funds.
3. KYC is a continuing duty. Further customer due diligence should be performed whenever material new information that casts doubt on the previous due diligence comes to light.
4. Where an issue of placee independence arises, the intermediary should carry out enhanced customer due diligence such as making reasonable enquiries about the placee's source of funds and who is ultimately responsible for originating the subscription instructions.
5. Absent any red flag, the SFC has not suggested that an intermediary should conduct customer due diligence on placees on a transaction-by-transaction basis.
6. The intermediary filing the Marketing Statement (Form D) bears the primary responsibility for ensuring that the placees listed in the statement are independent. That said, the sponsor (if it is not the filing entity) could also be prosecuted for turning a blind eye to the placees' lack of independence.
7. The filing intermediary needs to obtain sufficient comfort that its placees are independent before submitting a Marketing Statement to the Stock Exchange of Hong Kong Limited (**SEHK**). What is sufficient would depend on the facts of the case. The intermediary could, in addition to appropriate due diligence, consider obtaining written confirmation from the placee that he is not a nominee for or associated with any director or existing shareholder of the issuer.
8. The disciplinary sanction against C is an example showing that the SFC will have no hesitation in going after the senior management (such as the responsible or executive officer) of an intermediary if specific and identifiable responsibility can be placed on such individual(s).

9. An intermediary should ensure that relevant regulatory requirements and its internal policies and procedures (such as KYC procedures) are effectively communicated to all relevant staff through training and providing guidance when issues arise.
10. An intermediary should have an effective system for internal reporting of suspected breaches. This includes an ability to report directly to independent monitoring functions and clear procedures for follow up actions.

Background

The Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (**Listing Rules**) contain restrictions on subscriptions by directors of the issuer and their close associates, and existing shareholders of the issuer. The Placing Guidelines at Appendix 6 to the Listing Rules require all distributors to separately provide the SEHK with a Marketing Statement (Form D) before the listing date, and also to keep a record of all placees for at least three years. The Marketing Statement requires the provision of information by each distributor on the number and nature of placees and confirmation that, to the best of knowledge, none of the shares placed have been placed with directors or their close associates, or existing shareholders.

In addition, the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**) contain KYC requirements under which an intermediary needs to establish from its clients their financial situation, investment experience and investment objectives, as well as their identities as to whether they are ultimately responsible for originating the relevant instructions.

The Disciplinary Actions

A acted as one of the joint sponsors and bookrunners, and B as one of the joint lead managers, in the listing of a company (**Listco**) in 2009. C was a responsible officer of B at the material time.

Listco referred certain placees (**Placees**) to A which in turn referred them to B to open accounts for the subscription of the offer shares. No KYC due diligence was conducted on the Placees before their subscriptions were accepted.

Initially, demand was subdued and the listing risked falling through. Shortly after B raised the level of margin financing to be provided to the Placees upon Listco's request, the subscription sizes of four Placees suddenly surged. A allocated the shares to these Placees despite a number of red flags indicating that the orders of the Placees belonged to Listco:

- The Placees were friends and families introduced by Listco.
- Listco requested that B increase the level of margin financing to be extended to these Placees so that their subscriptions could be boosted to prevent the listing from falling through.
- The subscriptions of these Placees did increase and surged by as much as tenfold, far exceeding their declared net worth.
- Listco was actively involved in updating A on the size of these Placees' orders.
- There were indications from telephone conversations between B and these Placees that the Placees were relying on Listco for financial assistance in their subscriptions.
- The Placees raised questions regarding third-party settlement of their subscriptions.

Also worthy of note are the following internal control deficiencies and compliance failings highlighted in the SFC's Statements of Disciplinary Action:

- A responsible officer of A questioned the independence of these Placees and escalated the same to his supervisor. However, no follow up action was taken.

- None of the responsible account executives of B were aware of the KYC requirements under the Code of Conduct or the firm's Group compliance manual.
- A and B each considered that it was the other's responsibility to perform KYC checks on the Placees.
- Instead of inquiring into their source of funds, B advised the Placees to settle their allocations by cash or cashier's orders in order to circumvent B's internal policies on third party transactions.
- A had not received independence confirmations from all of the placees before submitting the Marketing Statement to the SEHK.

The SFC concluded that A and B (among other things):

- failed to conduct customer due diligence and perform ongoing scrutiny of the accounts of certain Placees;
- turned a blind eye to the lack of independence of these Placees;
- facilitated the listing by ensuring that margin financing would be extended to the Placees notwithstanding its suspicion of their non-independence; and
- failed to ensure that submissions to the SEHK were true, accurate and not misleading.

C was found to have failed to:

- ensure that all Placees were independent; and
- conduct customer due diligence on the Placees and satisfy himself on reasonable grounds that the subscriptions originated from them, and supervising his subordinate to do the same.

Copies of the SFC Statements of Disciplinary Action can be accessed here: (1) [Statement in relation to A and B](#); (2) [Statement in relation to C](#).

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